United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-4162

Signed

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FEDERAL BULK CARRIERS, INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

MYRON C. BAUM,
Acting Assistant Attorney General,

GILBERT E. ANDREWS,
GARY R. ALLEN,
DANIEL F. ROSS,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

TABLE OF CONTENTS

CITATIONS

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-4162

FEDERAL BULK CARRIERS, INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

In a transaction qualifying for capital gain treatment, taxpayer sold its stock and notes in a Canadian corporation, Federal Tankers Limited (all of the securities of which had theretofore been owned by taxpayer and another corporation which joined in the sale), whose only substantial asset was a tanker leased, for a 15-year term, to an unrelated third party. As part of this transaction, the sellers were required to set aside part of the purchase price in a newly formed Canadian corporation, Bessbulk Limited, which was required to enter an

agreement that effectively guaranteed the purchaser a specified level of earnings on the vessel over the remaining term of the lease. Thereafter, taxpayer sold its stock and other securities in Bessbulk Limited to the purchaser of the Federal Tankers securities for an amount equal to taxpayer's share of Bessbulk's net worth less the remaining deficit between projected earnings and purchaser's actual earnings on the lease of the vessel. The issue presented is whether the Tax Court correctly decided that taxpayer was not entitled to an ordinary loss or business expense deduction on the latter transaction, but that, even ignoring the form of the transaction as a sale of capital assets, any loss on the Bessbulk sale amounts to a repayment of a portion of the purchase price of the Tankers sale and, under Arrowsmith v. Commissioner, 344 U.S. 6 (1952), the loss on the repayment must be characterized as a capital loss.

STATEMENT OF THE CASE

This appeal involves deficiencies in federal income taxes determined to be due from Federal Bulk Carriers, Inc. (hereinafter taxpayer) in the following amounts for the following years (R. 94)[1/]:

1962	$ 992.41
1964	1,041.56
1965	3,293.66
1966	31,030.19
1967	15,016.00
1968	53,288.65

1/ "R." references are to the separately bound record appendix.

The opinion of the Tax Court (Judge Raum), is reported at 66 T. C. 283 and was filed on May 18, 1976. (R. 71.) Decision in favor of the Commissioner was entered on May 18, 1976, and the notice of appeal was timely filed by taxpayer on June 24, 1976. (R. 95.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The relevant facts, as stipulated (R. 28-39) and as found by the Tax Court (R. 72-86), may be summarized as follows:2/

Taxpayer and Bessemer Securities Corporation (Bessemer) owned 60 percent and 40 percent, respectively, of the stock and notes of Federal Tankers Limited (Tankers), a Canadian corporation organized to build and charter an oil tanker. Tankers organized wholly owned Canadian subsidiary, Federal Petroleum Carriers, Limited (Carriers), which contracted to have the 40,000-ton tanker vessel (the Monarch) built. (R. 73-74.) The vessel was delivered in 1959. (R. 74.)

2/ At the very outset, it should be noted that the "facts" asserted in the "Preliminary Statement" and "Statement of Facts" (indeed even in the "Issue Presented") set forth in taxpayer's opening brief (pp. 1-12) significantly differ from the "facts" found by the Tax Court in a number of rather critical respects. We shall, of course, deal with these discrepancies between the Tax Court's and taxpayer's respective views of the transactions in question in our argument, infra. It suffices to note here that taxpayer's repeated assertions as "facts" (Br. 2, 5, 8, 10, 11) that taxpayer and the other parties to the transactions in question had entered an agreement "to share operating profits and losses" on the vessel which was, ultimately, the subject of these transactions, and that the amounts taxpayer seeks to deduct reflect its payment of its "share" of such operating losses under the alleged agreement, are not only at odds with the rather extensive findings actually made in this regard (R. 71-85), but also were specifically rejected by the Tax Court (R. 89-91).

The Monarch was not intended to be operated by taxpayer, Tankers or Carriers for their own account. Instead, it was leased, a year before it was completed, to an unrelated corporation, Imperial Oil Limited (Imperial) for a 15-year term, by means of a complex charter arrangement dictated by the financing arrangements for the Monarch.[3/] (R. 74-76.) Both Tankers and Carriers were essentially shells. Neither corporation ever had any employees or conducted any business apart from the lease of the Monarch. (R. 77.)

Pursuant to a sales agreement (the "1961 Sales Agreement") (Ex. 34) dated July 31, 1961, taxpayer and Bessemer sold their Tankers stock and notes to Maple Leaf Mills Limited (Maple Leaf), an unrelated Canadian corporation, for Can. $2,325,000. The parties thereto also agreed to a "scheme of reorganization" whereby Maple Leaf was to purchase the Monarch from Carriers (which upon the sale of the Tankers stock to Maple Leaf would become the latter's second-tier subsidiary) and assume the obligations of Carriers. The sale by taxpayer of its Tankers stock and notes to Maple Leaf constituted a sale of capital assets for federal income tax purposes. (R. 78.)

Simultaneously with the sale of their interests in Tankers, and as a condition of that sale (Br. 20), taxpayer and Bessemer formed Bessbulk Limited (Bessbulk), a Canadian corporation with

---

3/ Under this arrangement, the vessel was "bareboat" chartered by Carriers to Imperial. Simultaneously, the vessel was bareboat chartered back to Tankers on essentially the same terms. Tankers, in turn, "time" chartered the Monarch to Imperial. All charter terms extended to September 24, 1974. (R. 74-76.)

an initial capital of Can. $1,943,000 derived from the proceeds of the sale of their Tankers stock and notes to Maple Leaf. Taxpayer owned 60 percent of the shares and approximately 60 percent of the debentures of Bessbulk; the remaining shares and debentures were held by Bessemer. Pursuant to a commitment agreement, dated July 31, 1961, which was also a part of the sale of the Tankers securities, taxpayer and Bessemer agreed with Maple Leaf to cause Bessbulk to become party to an indemnity agreement (the "1961 Indemnity Agreement") (Ex. 36) (R. 78-79).

The 1961 Indemnity Agreement set forth estimates of revenue that would be derived from and expenses that would be incurred in operating the Monarch over the term (15 years) of the charter to Imperial. Projected annual revenue ranged from Can. $1,257,525 at the beginning of the charter term to Can. $1,202,850 at the end of such term. Projected annual expenses (including off-hire insurance, for which separate figures were stated, but not including any allowance for depreciation in respect of the Monarch) ranged from Can. $413,800 at the beginning of the charter term to Can. $500,000 at the end of that term. Bessbulk agreed to pay Maple Leaf its annual income to the extent available and necessary to indemnify Maple Leaf in the event the Monarch's actual operating profits fell short of projected operating profits as set forth in the agreement. Maple Leaf, in turn, agreed that at the expiration of the Charter to Imperial, or upon the earlier sale of the Monarch (events which

terminated the indemnity agreement) Bessbulk would receive 35 percent of the amount by which the Monarch's actual operating profits exceeded projected operating profits. (R. 79-80.)

Under the 1961 Indemnity Agreement, Bessbulk was prohibited from issuing additional shares of stock or amending the terms of its outstanding debentures. It could not engage in the active conduct of any business, but could only invest in the "preferred shares or bonds or debentures or other evidences of indebtedness in which the Canadian and British Insurance Companies Act, Part III, states that a company registered under it may invest its funds". The payment of dividends, repurchase of its shares and retirement of its debentures were all restricted. At no time did Bessbulk have any employees. (R. 80.)

Thereafter, taxpayer and Bessemer agreed to sell their Bessbulk shares and debentures to Maple Leaf pursuant to a sales agreement dated June 20, 1963 (the "1963 Sales Agreement") (Ex. 38.) The purchase price was to be determined at the earlier of the expiration of the charter of the Monarch to Imperial or the sale of the Monarch by Maple Leaf. The purchase price was to be based upon, among other things, the net worth of Bessbulk and the operating experience of the Monarch. The agreement incorporated the same revenue and expense projections set forth in the 1961 Indemnity Agreement. For any year in which the operations of the Monarch produced an actual loss, the amount of the loss plus the projected operating profits for that year was defined

as a "net revenue decrease". If operations produced profits less than projected operating profits, the difference was also a "net revenue decrease". But actual profits in excess of projected profits produced a "net revenue increase" in the amount of the excess. This agreement also provided for the periodic distribution to Maple Leaf of Bessbulk's net income to the extent necessary to compensate Maple Leaf for any "net revenue decreases" which had not been otherwise offset by "net revenue increases". (R. 81-82.)

Upon termination of the charter to Imperial or sale of the Monarch by Maple Leaf to someone unrelated to it, the agreement required computation of a "charter period deduction" defined as the amount, if any, by which aggregate "net revenue decreases" exceeded aggregate "net revenue increases" and distributions of Bessbulk income to Maple Leaf. The excess of the net worth of Bessbulk over the "charter period deduction" would then constitute the "basic purchase price" of the Bessbulk shares and debentures, 60 percent of which would be payable to taxpayer. This basic purchase price was subject to further adjustment, however, whereby Maple Leaf would be required to pay additional amounts out of profits earned in operating the Monarch after expiration of the Imperial charter or gain earned upon the sale of the vessel. In no event, however, could the total amount of this adjustment exceed the sum of the "charter period deduction" and amounts of Bessbulk income previously distributed to Maple Leaf. (R. 82.)

Pursuant to an agreement dated November 18, 1965 (one day prior to Maple Leaf's sale of the Monarch to an unrelated third party (R. 37)) petitioner, Bessemer and Maple Leaf terminated the 1963 Sales Agreement. This agreement (Ex. 43) also provided for the sale of taxpayer's and Bessemer's interest in Bessbulk and incorporated the same basic formula for determining the purchase price of the Bessbulk shares and debentures adopted in the 1963 Sales Agreement, which in turn had been based upon the 1961 Indemnity Agreement (R. 83).

During the period from July 31, 1961, through November 18, 1965, actual operating profits from the Monarch consistently fell short of the operating profits projected in the 1961 Indemnity Agreement. At the time the November 18, 1965, agreement was executed, the parties estimated the amount by which the cumulative deficit in actual operating profits exceeded Bessbulk's income for that period. Sixty percent of that amount--i.e., the portion thereof which would reduce the price paid for taxpayer's Bessbulk shares and debentures--was $501,684.52. However, gain had been realized on the liquidation of a portion of Bessbulk's assets. Sixty percent of this gain--which would increase the purchase price paid taxpayer--amounted to $100,907.59. On the basis of these computations and the provisions of the November 18, 1965, agreement Maple Leaf paid taxpayer Can. $768,558 for its Bessbulk shares and debentures. This price was subject to adjustment after final audit of profit or loss from the Monarch's operations for the period ending November 19, 1965.

A final audit determined that the difference between projected and actual profits was somewhat greater than previously estimated. Sixty percent of the additional operating profits deficiency totaled $48,011.81. (R. 83-84.) This amount, reduced by taxpayer's share ($25,771.32) of an additional gain realized in 1966 on the sale of a deposit (to which taxpayer had contributed under the 1965 agreement) required under the Canadian Vessel Construction Assistance Act to avoid recapture of excess depreciation claimed by Maple Leaf in respect of the Monarch, was paid by taxpayer to Maple Leaf in 1966. (R. 84-85.)

On its federal corporate income tax return for 1965 taxpayer claimed a deduction in the amount of $400,776.93 (i.e., the amount of taxpayer's share of the reduction in purchase price under the 1965 sales agreement--$501,684.52 minus $100,907.59) for "Loss by indemnification to Maple Leaf Mills Limited for guarantee of ship operation income pursuant to agreements". On that return taxpayer reported gross income of $25,407.89 and claimed deductions totaling $411,171.16. As a result taxpayer filed refund claims for each of the years 1962, 1963 and 1964, on which it claimed net operating loss carryback deductions. It received tentative allowances of $992.41, $2,276.15 and $3,988.16 for those years, respectively. (R. 85.)

On its return for the year 1966 taxpayer deducted $22,240.49 (i.e., the net amount paid Maple Leaf in that year) as an "Indemnification for guarantee of ship operation income pursuant

to agreements". It also claimed a net operating loss carryover deduction in the amount of $356,382.54. On its returns for the years 1967 and 1968, taxpayer claimed net operating loss carryover deductions of $337,491.25 and $292,666.24, respectively. (R. 85.)

On audit of the taxpayers' returns for the years in question, the Commissioner determined (R. 23)--

> that "loss by indemnification" deductions claimed in the amounts of $400,776.93 and $22,240.49 for the taxable years ended December 31, 1965 and December 31, 1966, respectively, do not constitute ordinary loss deductions.

Accordingly, the Commissioner disallowed the net operating loss deductions for the years 1962 through 1964 and 1966 through 1968 (which were based on carrybacks and carryforwards of the foregoing claimed "loss[es] by indemnification"). The Commissioner also determined (R. 17) that for the year 1966 taxpayer was a personal holding company subject to the special tax on undistributed personal holding company income. (R. 86.)

Below, the Tax Court rejected the taxpayer's contentions that the downward adjustments to the sales price of its Bessbulk securities should be deductible as an ordinary and necessary business expense or an ordinary loss on the theory that it was engaged in a joint venture with Bessemer and Maple Leaf to share the profits and losses arising from the operation of the Monarch, and held that even if the form of the transaction as a sale of capital assets (i.e., taxpayer's Bessbulk securities)

is to be ignored, the transaction, in substance, simply represents a repayment of a part of the original sales price received for taxpayer's Tankers' securities, and that such repayment must be treated as a capital loss under the doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952). (R. 16-23.) From its decision sustaining the Commissioner's deficiency determinations (R. 94), taxpayer appeals.

SUMMARY OF ARGUMENT

The Tax Court was clearly correct in holding that taxpayer is not entitled to ordinary loss or ordinary expense treatment on the transaction in question. Indeed, as the Tax Court noted (R. 86-87), what taxpayer is seeking is ordinary loss treatment on the sale of stock and other securities which it does not deny were capital assets in its hands. Nevertheless, taxpayer argues that the form in which it cast the transaction (and, indeed, the form of Bessbulk as a separate corporate entity) should be totally disregarded, and that the transaction should, instead, be viewed as simply a profit and loss sharing venture among Bessemer, itself and Maple Leaf with respect to the operation of the Monarch. But, as the court below concluded, even if the arrangements among these parties are denuded of their outward forms, the substance of these arrangements is not a joint venture with respect to the operation of the Monarch, but, instead, simply an elaborate device to effect a guaranty given Maple Leaf by taxpayer and Bessemer on the sale of their Tankers

stock and notes. Accordingly, under the doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), the portion of the original sales price ultimately repaid to Maple Leaf may be treated only as a capital loss, just as the gain on the original sale was taxable as a capital gain. Stripped of the confusing array of corporations, charters, and straw parties, etc., what occurred is that taxpayer and Bessemer sold their interest in Tankers (whose only substantial asset was the Monarch) for $2,300,000 and took capital gains treatment on their profit to Maple Leaf on that sale. But, in order to get this price, they had to guarantee the purchaser a minimum level of operating profit over the remaining term of a lease of the vessel in question, and they were required to secure that guaranty by placing $1,900,000 of the money received on the sale in what amounted to an escrow (the Bessbulk corporation). When the guaranty period ended, on the sale of the Monarch by Maple Leaf, aggregate operating profits were well below what had been projected and guaranteed. Thus, taxpayer was required to give up a net of some $400,000 of its share of the money that had been placed in escrow (Bessbulk). They now wish to take ordinary deductions for the $400,000 repayment of funds upon which they paid only a capital gains tax when the funds were received. If taxpayer is allowed the deductions it claims, it will have profited by the difference between capital gains tax rates and the ordinary income tax rate on $400,000. For example, assuming a capital gains tax rate of 25 percent and ordinary corporate tax rate of 48 percent, taxpayer would

have paid $100,000 tax with respect to the receipt of the $400,000, but the deduction, upon its repayment would have lowered its taxes by $192,000, yielding a "tax" profit, of $92,000 on what is, otherwise, an economic wash. This result is squarely prohibited by Arrowsmith, as further explained in United States v. Skelly Oil Co., 394 U.S. 678, 684-685 (1969). The Arrowsmith doctrine provides that since taxpayer took capital gains treatment when it received the $400,000, it is entitled only to a capital loss deduction upon the repayment. Even though the repayment takes place as a separate transaction, where its "genesis" is a prior capital gains transaction it must be characterized, for tax purposes, in the same manner as that related capital gains transaction. See Cummings v. Commissioner, 506 F. 2d 449, 451 (C.A. 2, 1974).

Taxpayer objects to the application of the Arrowsmith doctrine in this case. He claims first that the result reached is inconsistent with a Canadian case, involving the same transaction, in which case the Canadian purchaser of the Monarch was held to have received income, under Canadian tax law, upon the receipt of the guaranty payment. Taxpayer's theory is that the Canadian court found the guaranty payments to be income from the operation of the ship Monarch and not an adjustment in the sales price of a capital asset. Taxpayer would impose this finding upon the United States tax authorities. First, there is no requirement that the United States and Canadian courts view the same transaction in the same manner.

Just as the possible application of Arrowsmith to taxpayer here was no concern to the Canadian court in determing the tax consequences to Maple Leaf, the decision of the Canadian court has little or no bearing on the application of Arrowsmith to the taxpayer here. Furthermore, the question at issue in the Canadian case was whether or not the guarantee payment was an abatement of the sales price of the Bessbulk securities. The Tax Court found the guaranty resulted in an abatement of the sales price of the Tanker securities. Thus, the two cases do not even deal with the same question.

Taxpayer makes the claim that the effect of these two cases is to deny either party a deduction for the "losses" of the Monarch. This claim is ridiculous. The Tax Court allowed taxpayer a deduction--the issue is how the deduction should be characterized, not whether taxpayer is to have a deduction. Secondly, it does not appear on the record that the Monarch sustained any "losses". What taxpayer guaranteed Maple Leaf Mills is that the Monarch would produce operating profits (before depreciation) of approximately $700,000 per year. (Slip Op. 9.) Thus, what is in issue is simply the failure of profits to meet expectations.

Next, taxpayer complains that the position taken by the Commissioner and the Tax Court herein converts the sale of the Tankers securities into an open transaction and that the characterization of the guaranty payment as a capital loss is contrary to Rev. Rul. 58-402 1958-2 Cum. Bull. 15. In the first place, Rev. Rul. 58-402, supra, has nothing to do with

the characterization of contingent payments as ordinary or capital. The Revenue Rulings deals with, inter alia, the characterization of receipts as ordinary income or return of capital. Further, this case does not involve an open transaction and the Tax Court opinion does not make it one. An open transaction is one in which gain or loss cannot be calculated within a single annual accounting period because some part of the deferred consideration involved cannot be immediately valued. That problem did not exist in this case. Gain on the sale of the Tankers' securities was accurately calculated and reported as capital gain in 1961. Loss on the sale of the Bessbulk securities was calculated and the loss was claimed in entirely different accounting periods, 1965 and 1966. The question is whether the loss on the guaranty was capital or ordinary, not whether the sales price of the Tankers securities could be calculated with accuracy at the time of the sale in 1961. Indeed, this is precisely the same context in which Arrowsmith itself was decided, and, as the Court there noted, the fact that the original capital gain transaction was closed in a prior year does not prevent the subsequent loss from being treated as a capital loss by reference to the nature of the prior closed transaction.

Finally, taxpayer argues that since the operating profit shortfall of the Monarch arose after the sale of the Tankers securities, the guaranty transaction was somehow entirely independent of the Tankers sale, and that the application of Arrowsmith is, therefore, improper. This argument is simply

impossible to square with recent cases in several courts of appeals, including this Court's decision in Cummings, supra, where the Arrowsmith doctrine has been applied even though the repayment was due to events occurring after the original capital gain transaction. In sum, taxpayer has presented no reason for overturning the Tax Court's application of the Arrowsmith doctrine in this case, and its decision should be affirmed.

ARGUMENT

WHERE TAXPAYER SOLD SECURITIES AND REPORTED THE GAIN THEREON AS CAPITAL GAINS AND, IN CONNECTION WITH THE SALE OF THOSE SECURITIES, MADE A GUARANTEE WHICH RESULTED IN TAXPAYER REPAYING PURCHASER A PORTION OF THE SALES PRICE IN LATER YEARS, THE TAX COURT CORRECTLY HELD THAT UNDER THE ARROWSMITH DOCTRINE THE REPAYMENTS WERE DEDUCTIBLE AS CAPITAL LOSSES

This case involves the tax treatment of losses taxpayer suffered in 1965 and 1966 on its sale of stock and notes of a Canadian corporation, Bessbulk Limited, which had been organized by taxpayer and Bessemer Securities Corporation as part of the overall arrangements surrounding their sale of securities of another corporation (Tankers) jointly owned by them to the same purchaser. Thus, in form, taxpayer simply sold capital assets--viz., its stock and debentures in Bessbulk--at a loss. While taxpayers are, as a general rule, bound by the form in which they choose to cast their transactions, particularly with respect to their formation and dealings with separate corporate entities, (see Higgins v. Smith, 308 U.S. 473, 477 (1940); Gray v. Powell, 314 U.S. 402, 414 (1941)), taxpayer nevertheless seeks to

avoid capital loss treatment by arguing that the form of the transaction (and, indeed, the form of Bessbulk as a separate corporate entity) should be disregarded. As the Tax Court concluded, however, it really makes no difference in this case whether or not the transaction in question is denuded of its outward form, since the underlying substance of this transaction is not the participation by taxpayer in a joint venture in the operation of the Monarch, but rather the repayment of a portion of the amount realized by taxpayer on sale of its Tankers stock and notes pursuant to a guaranty it was required to give at that time. Given this essential nature of the transaction, just as the taxpayer treated the sale of its Tankers securities as a capital gain transaction, its loss on the instant transaction must be treated as a capital loss under the doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

The sale of the Bessbulk securities was the culmination of a series of transactions, going back to 1961, which involved, in essence, the sale of the tanker vessel, Monarch. In 1961, taxpayer and Bessemer sold their stock and notes in Tankers to Maple Leaf for Can. $2,325,000 and taxpayer took capital gains treatment on its profit. (R. 77-78.) Tankers had as its wholly owned subsidiary, Carriers, which, in turn, owned the ship Monarch, which was leased, for a 15-year term, to an unrelated third party. (R. 73-74.) As soon as it gained control of Tankers, Maple Leaf arranged for the transfer of the title of the Monarch to itself (Maple Leaf). (R. 78.)

As a condition of the sale of the Tankers stock and notes, taxpayer and Bessemer, in effect had to give Maple Leaf a guaranty that the Monarch would have specified minimum operating profits each year. (Br. 20.) This guaranty was secured by the formation of Bessbulk,[4/] into which taxpayer and Bessemer put $1,900,000 of the money received for the Tankers stock and notes. (R. 78-80, 92; Br. 20.) Bessbulk then became a party to an indemnity agreement (the 1961 Indemnity Agreement) (Ex. 36) which was to serve to carry out that guaranty. Bessbulk was prohibited from issuing additional shares, changing the terms of its debentures, or engaging in the active conduct of any business. Its activity was restricted to investment in certain securities. Bessbulk's right to pay dividends, repurchase its shares, or retire its debentures were all restricted. (R. 80.) Thus, Bessbulk was essentially an escrow fund.

In 1963, the agreement was adjusted by the 1963 Sales Agreement (Ex. 38), under which taxpayer and Bessemer agreed to sell their interest in Bessbulk to Maple Leaf for a price to be determined upon the expiration of the charter to Imperial or the sale of the Monarch by Maple Leaf, whichever came first. The purchase price was to be determined by reference to the net worth of Bessbulk and the operating experience of the Monarch. The agreement incorporated certain projections of operating profits set forth in the 1961 Indemnity Agreement.

4/ Below, taxpayer's counsel characterized Bessbulk as an "accounting mechanism" or "cash drawer" (R. 51-52), the function of which was to carry out the admitted guaranty made to Maple Leaf by taxpayer and Bessemer (R. 57-58).

For any year in which the operations of the Monarch produced a loss, the amount of the loss plus the projected operating profit for that year was defined as a "net revenue decrease." If operations produced profits which, however, were less than projected profits, the difference was also a "net revenue decrease". But actual profits in excess of projected operating profits produced a "net revenue increase" in the amount of the excess. The agreement provided for the periodic distribution to Maple Leaf of Bessbulk's net income to the extent necessary to compensate Maple Leaf for any "net revenue decreases" which had not been otherwise offset by "net revenue increases". (R. 81-82.)

Upon termination of the charter to Imperial or sale of the Monarch by Maple Leaf to someone unrelated to it, the agreement required computation of a "charter period deduction" defined as the amount, if any, by which aggregate "net revenue decreases" exceeded the aggregate of "net revenue increases" and prior distributions of Bessbulk income to Maple Leaf. The excess of the net worth of Bessbulk over the charter period deduction would constitute the "basic purchase price" of the Bessbulk shares and debentures, 60 percent of which would be payable to taxpayer. In short, the 1963 Sales Agreement provided that Maple Leaf was to be reimbursed out of Bessbulk's income for any shortfall between actual operating profits and the guaranteed operating profits. If Bessbulk's income was insufficient to cover the shortfall in operating profits, Maple Leaf was to be

reimbursed by purchasing Bessbulk (the assets of which were stocks and bonds) at less than its net worth. (R. 81-82.) When the guaranty period ended, and the sale of Bessbulk securities was triggered by the sale of the Monarch by Maple Leaf in 1965, aggregate operating profits were well below what had been projected and guaranteed. Pursuant to the guaranty, taxpayer gave up a net amount of approximately $400,000 of the money that had been placed in escrow (Bessbulk) to make up the difference between Maple Leaf's shortfall in actual profits and the net income of Bessbulk previously paid over on this guaranty. (R. 84-85.) Taxpayer now wishes to take ordinary deductions for the $400,000 repayment to Maple Leaf of funds upon which taxpayer paid only capital gains taxes when the funds were received.

In the first place, since, as the Tax Court noted (R. 91-92), taxpayer failed to establish just why the parties structured their transaction in this manner, it seems rather questionable that taxpayer has shown grounds to be relieved of the form of this "maze of agreements" in any event. But it makes no real difference in this case whether or not the transaction is treated as a sale of capital assets. As the Tax Court correctly found, even if the form of these arrangements is disregarded, the matter is controlled by the Arrowsmith doctrine and the repayment of $400,000 to Maple Leaf under the guaranty must therefore be characterized as a capital loss in any event. The doctrine of Arrowsmith was neatly summarized by the Supreme Court in

United States v. Skelly Oil Co., 394 U.S. 678, 684-685 (1969), when the Court said:

> For instance, it is well settled that the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss. Arrowsmith v. Commissioner, 344 U.S. 6 (1952). The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income.

Accord: Cummings v. Commissioner, 506 F. 2d 440, 451 (C.A. 2, 1974), cert. denied, 421 U.S. 913 (1975); Brown v. Commissioner, 529 F. 2d 609, 612-614 (C.A. 10, 1976); Anderson v. Commissioner, 480 F. 2d 1304, 1306-1307 (C.A. 7, 1973); Mitchell v. Commissioner, 428 F. 2d 259, 262-263 (C.A. 6, 1970), cert. denied, 401 U.S. 909 (1971), and the other cases cited by the Tax Court in this regard (R. 92).

This case would appear to be a classic example for the application of the Arrowsmith rationale set forth above. Taxpayer received money on its sale of Tankers securities. That money was taxed at the special lower rate for capital gains. Pursuant to the sales agreement, taxpayer was required to set aside a portion of the purchase price to indemnify the purchaser, Maple Leaf, if operating profits of the Monarch did not reach or exceed the levels that taxpayer guaranteed that they would. The operating profits of the Monarch did not reach the guaranteed levels, and taxpayer repaid a portion of the purchase price to

Maple Leaf by allowing Maple Leaf to make a bargain purchase of Bessbulk stock. Since taxpayer paid only capital gains tax when it received the money from Maple Leaf, taxpayer is entitled only to a capital loss deduction upon the repayment. Skelly Oil, supra.

In spite of what we perceive as the clear applicability of Arrowsmith, supra, and its progeny to the facts of this case, taxpayer objects. It claims that the Tax Court failed to accord proper weight to the Canadian case, Maple Leaf Mills Ltd. v. Minister of National Revenue, 72 Dom. Tax Cas. 6166 (1972) (Ex. 45), and that the application of the Arrowsmith doctrine is erroneous under United States tax principles.[5/] Maple Leaf Mills Ltd. v. Minister of National Revenue, supra, is a Canadian case dealing with the tax consequences to Maple Leaf of its purchase of Bessbulk from taxpayer and Bessemer. The case held that the benefit of the bargain purchase of Bessbulk securities was received in lieu of income from the operation of the Monarch and that under Canadian tax law, such receipts were "on income account" and not a matter "on capital account" as Maple Leaf had contended. (See Ex. 45, page 7.) Taxpayer claims (Br. 16) that the Tax Court, "refused to even consider the Canadian case." This is simply not true. The Tax Court discussed the Canadian case in a lengthy footnote. (R. 93.) Far from refusing to consider the

5/ Taxpayer also alludes, in a puzzling fashion (Br. 19) to the Income Tax Treaty between the United States and Canada. No claim involving this treaty is articulated. We do not understand how the treaty might be relevant to the United States taxation of a United States corporation, particularly where, as here, there is no indication that taxpayer suffered any double taxation.

Canadian case, the Tax Court specifically stated (R. 93), "We have reviewed that decision and find nothing therein which persuades us to reach a different result here." The Tax Court simply found that Canadian case to be unpersuasive authority for taxpayer's position. Since the Canadian decision is not binding on either this Court or the Tax Court, its value as precedent in this case depends solely upon the persuasive power and logic of the reasoning by which the Trial Division of the Federal Court of Canada reached its decision. That reasoning, for the most part, is not disclosed in the somewhat cryptic opinion. Indeed, taxpayers do not attempt to discuss the reasoning of the Canadian court. They refer only to its conclusions.

We also have a fundamental disagreement with taxpayer's characterization of the Canadian case as involving the same matters as are at issue here. Taxpayer states (Br. 17):

> Thus the factual issue in Canada was the precise factual issue in the Tax Court--whether the payments from Federal Bulk to Maple Leaf resulted from operating the Monarch or from adjusting the sale price of a capital asset.

That is not at all how we understand the opinion of the Canadian court. We understand that court to have ruled that the payment from Federal Bulk to Maple Leaf resulted from the operation of the Monarch and was accomplished by adjusting the sales price of the Bessbulk securities. (Ex. 45, p. 7.) Thus, far from choosing between the alternatives posed by taxpayer, the Canadian court found that they both were correct. The Canadian court, so far as we understand its opinion, expressed

no view with respect to the relationship, or lack thereof, between the sale of the Tankers securities and the guaranty, that the Monarch would generate certain minimum operating profits.

Taxpayer attempts (Br. 18), "To put the relationship of the Canadian case with the Tax Court case in proper perspective," by claiming that, if both decisions were United States decisions and both taxpayer and Maple Leaf were United States taxpayers, "neither Maple Leaf nor Federal Bulk would be entitled to a deduction for the operating losses of the Monarch." This statement is preposterous. There is simply no indication on the record of this case that Maple Leaf had operating losses on the Monarch, but rather, the reduction in the price of the Bessbulk securities arose from the failure of operating profits to reach guaranteed levels (R. 79-80, 83-84). Even if there were losses, however, Maple Leaf, having been made whole by the guaranty, would have suffered no net loss to deduct (i.e., any such operating loss would be offset by guaranty income). Moreover, taxpayer, which did suffer an economic detriment as a result of the guaranty portion of the transaction has been conceded the right to a loss deduction for the guaranty payment by the Government. The only question to be decided is how taxpayer's deduction is to be characterized (i.e., as capital or ordinary). Just as any possible consideration of the Arrowsmith doctrine had no bearing on the Canadian trial court's resolution of the Maple Leaf case, its decision in the Canadian case sheds little or no light on the capital vs. ordinary loss question presented here.

Taxpayer also makes a number of arguments, based upon alleged "United States tax principles". (Br. 20.) He argues first that the application of the Arrowsmith doctrine to the facts of this case somehow converts the sale of the Tankers securities in 1961 into an open transaction[6/] in contravention of longstanding rules and contains the seed of great revenue loss. (Br. 20-24.) This claim is utterly without merit. Indeed, this argument--which suggests that Arrowsmith is only applicable to open transactions or that its application serves to "open" otherwise closed transactions--is nothing less than an oblique attack on the Supreme Court's decision in Arrowsmith itself. Like the instant case, Arrowsmith involved a repayment to the purchaser on a previously closed capital gain transaction. There, too, the taxpayer argued--in a somewhat more straightforward manner--that ordinary loss treatment was available since the prior transaction was "closed" and that treating the loss as capital in nature would violate the annual accounting period principles applicable except in the narrowly defined area of "open" transactions. Noting that one Court of Appeals had accepted such an analysis, this Court squarely rejected that

6/ A so-called open transaction is one on which gain or loss on a deferred payment sale cannot be calculated within a single annual accounting period because some part of the deferred consideration involved has no presently ascertainable fair market value. Calculation of gain or loss on the transaction is deferred and the transaction is said to be "open" until the unvalued consideration is exchanged for money or money's worth. Burnet v. Logan, 283 U.S. 404, 413 (1931). This deferral is contrary to the ordinary convention of annual accounting periods adopted by our tax laws and is, therefore, severely limited. (See, e.g., Treasury Regulations on Income Tax (1954 Code), §1.1001-1(a) and §1.453-6(a)(2) (26 C.F.R.).)

argument, Commissioner v. Arrowsmith, 193 F. 2d 734, 735 (1952), and the Supreme Court agreed 344 U.S., pp. 8-9.

Here, too, the application of the Arrowsmith doctrine does not serve to convert the Tankers sale to an open transaction. Gain on the sale of the Tankers securities--which was not a deferred payment sale--was accurately calculated and reported as capital gain in 1961. That transaction was closed in 1961. Losses on the sale of the Bessbulk securities were calculated and claimed when they occurred, in 1965 and 1966, entirely different accounting periods. As in Arrowsmith, treatment of such losses as capital losses by reference to the original capital gain transaction does not serve to "re-open" that closed transaction.[7/]

7/ Taxpayer's citation of Rev. Rul. 58-402, 1958-2 Cum. Bull. 15 (Br. 23) in connection with this argument is similarly inapposite. The Revenue Ruling does not purport to deal with the application of Arrowsmith to payments later required to be made by the seller of capital assets. Rather, it simply reiterates the general rules for the characterization of receipts under contract rights obtained pursuant to corporate liquidations, which, of course, are treated as sales or exchanges of property for tax purposes. Furthermore, the Arrowsmith doctrine, as set forth in Skelly Oil, supra, is recognized exception to the general rule as to the characterization of subsequent losses incurred by the seller where such losses grow out of a prior capital gain transaction. The Arrowsmith doctrine simply re-characterizes what would otherwise be ordinary deductions so as to prevent windfall gains at the expense of the federal treasury.

Finally, taxpayer's argument that application of Arrowsmith here somehow serves to eliminate Section 453 (26 U.S.C.) (which deals with favorable tax treatment extended to qualifying installment sales) from the Code is nothing less than bizarre. As noted above, the sale of the Tankers securities was not even a deferred payment sale, let alone an installment sale, and the supposed relationship of Section 453 (as well as the "open" transaction problem) to the Arrowsmith doctrine is quite impossible to fathom. Cf. Campagna v. United States, 290 F. 2d 682, 685 (C.A. 2, 1961).

Secondly, taxpayer appears to argue that it is entitled to deduct the losses on the Bessbulk sale as ordinary losses because they grow out of a joint venture operation of the Monarch and are simply business losses. (Br. 21-23.) In the first place, the Tax Court found that there was no joint venture shown (R. 89-90) and taxpayer does not openly attack this finding as erroneous. Indeed, that finding is plainly correct. The arrangements with Maple Leaf clearly reflect a guaranty that Maple Leaf's operating profits would attain a specified level, and not a joint venture with a mutual sharing of profits and losses. As the Tax Court noted (R. 90-91), while the 1961 Indemnity Agreement did provide that Bessbulk would receive 35 percent of the amount of any excess of actual profits over projected profits, receipts were fixed, and it was unlikely that operating expenses would, in fact, be less than those already experienced. In short, Maple Leaf was assured that it would retain all anticipated profits, and would receive these amounts even if actual earnings were less. Taxpayer and Bessemer, by contrast, did not "share" losses with Maple Leaf, but rather were required to bear the economic burden of any difference between actual earnings and projected earnings. Thus, as the Tax Court concluded (R. 91), these arrangements were "hardly indicative of a joint venture." Beyond that point, however, we do not believe there would be any necessary change in result even if the arrangement could be treated as a joint venture. As we have shown above, the whole point of the Arrowsmith doctrine is to re-characterize or deny

deductions in situations where, but for a connection to earlier events, an ordinary loss would be allowed. If there was a joint venture here, it was entered into as a condition of the sale of the Tankers securities (Br. 20, 24; R. 92) and repayments pursuant to the alleged joint venture, accordingly, would be impressed with the tax characterization of the Tankers sale.

Finally, taxpayer argues (Br. 25 et seq.) that the payments in 1965 and 1966 grew out of events subsequent to the 1961 sale and that the application of the Arrowsmith doctrine is restricted to cases where the rep ment grows out of events which are fixed prior to the original receipt of funds (here the 1961 sale of Tankers securities). To support this argument, taxpayer selectively discusses a number of cases which Arrowsmith was applied under such circumstances, and dismisses a prior decision of this Court, Duveen Bros., Inc. v. Commissioner, 197 F. 2d 118 (1952), aff'g 17 T. C. 124 (1951) (which it concedes cannot be squared with its position in this regard) as a "deviation from the general rule" (Br. 29). Duveen is itself quite similar to the instant case, involving payments made pursuant to a guaranty given on the sale of capital assets.[8/] But wholly apart from the fact that Duveen cannot be distinguished on any meaningful basis, taxpayer's argument in this regard simply cannot be squared

---

8/ As authority for the proposition that payments made pursuant to such guaranties should be deductible as ordinary losses, taxpayer cites (Br. 29-30) two pre-Arrowsmith decisions of the Tax Court (Hess v. Commissioner, 7 T.C. 333 (1946); Hale v. Commissioner, 32 B.T.A. 356 (1935), aff'd on another issue, 85 F. 2d 819 (C.A. D.C., 1936) which do not appear to have been cited as authority for allowing ordinary loss deduction treatment for such payrents since Arrowsmith.

with a number of recent decisions (which taxpayer simply ignores) in which this Court and other appellate courts have applied Arrowsmith, supra, to repayments of short swing profits made by insiders on the sale and repurchase of stock which are required by Section 16(b) of the Securities and Exchange Act of 1934, c. 404, 48 Stat. 881 (15 U.S.C. §78p(b)). See Brown v. Commissioner, supra; Cummings v. Commissioner, supra; Anderson v. Commissioner, supra; and Mitchell v. Commissioner, supra.[9/] There the repayment (the Section 16(b) liability) grows out of the repurchase of securities within six months of the earlier sale of those same securities. The repayment of the Section 16(b) liability is still characterized by the tax treatment of the original sale. As the court said in Anderson, supra, p. 1307:

> Although no 16(b) liability would have attached had taxpayer simply sold his stock and not made an advantageous repurchase within six months, the fact that liability [and repayment] is predicated on the sale-purchase occurrence does not mean the 16(b) payments were not integrally related to the earlier sale.

Similarly, in Cummings, supra, p. 451, this Court said, "The nexus between the §16(b) repayment and the earlier capital gains is apparent" and went on to apply Arrowsmith, supra, to the 16(b) repayment. Taxpayer's attempt to restrict the application of Arrowsmith, supra, is simply not in accord with the decided cases.

9/ Taxpayer's failure even to acknowledge the existence of this highly relevant line of decisions is all the more remarkable in light of the fact that these cases are all discussed in one of the cases taxpayer does cite (Br. 27): Kimbell v. United States, 490 F. 2d 203, 205 (C.A. 5, 1974), cert. denied, 419 U.S. 833 (1974). It goes without saying, of course, that neither Kimbell nor the other cases taxpayer does discuss actually purport to limit the application of Arrowsmith in the manner taxpayer argues it has been limited.

As in the Section 16(b) cases, the loss here in question "had its genesis in the earlier sale" (Cummings v. Commissioner, supra, p. 451), and the application of Arrowsmith is equally appropriate.

In sum, taxpayer has failed to provide any cogent reason why Arrowsmith, supra, and Skelly Oil, supra, are not applicable to the repayment here. The Tax Court correctly applied the law to the facts of this case and determined that taxpayer was entitled only to capital loss deductions for the repayments made in 1965 and 1966.

CONCLUSION

For the reasons appearing above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

MYRON C. BAUM,
Acting Assistant Attorney General,

GILBERT E. ANDREWS,
GARY R. ALLEN,
DANIEL F. ROSS,
Attorneys,
Tax Division,
Department of Justice,
Washington, D. C. 20530.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 10th day of February, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

William F. Indoe, Esquire
Sullivan & Cromwell
48 Wall Street
New York, New York 10005

Gilbert E. Andrews/cas
GILBERT E. ANDREWS,
Attorney.